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Polish Economic Policy and Western  
Economic Leverage

Kelth Crane

July 1987

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This Note considers ways in which Western policy can influence the Polish economic debate. Western leverage in Poland is limited, as that country lies in the overwhelming political, economic, and military shadow of the Soviet Union. Nonetheless, economic policy instruments have some potential for influencing economic and other policies in Poland. Two Western economic policy goals stand out: the eventual servicing of the Polish hard-currency debt and the implementation of a more efficient, market-based economic system within the country. The latter would make it easier for Poland to service its debt and could lead to increased trade and, possibly, a more open political system. Western economic leverage appears to lie in its willingness to ease Polish debt repayment and to lower barriers to Polish exports, accomplished perhaps by trading concessions for concessions. International institutions not representing national policy interests would be best situated to provide pressure in the desired direction. (100)

# A RAND NOTE

N-2585-OSD/FF

## Polish Economic Policy and Western Economic Leverage

Keith Crane

July 1987



Prepared for  
The Office of the Secretary of Defense  
The Ford Foundation

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## PREFACE

This Note is based on a discussion paper prepared for a January 1987 RAND workshop conference on U.S. policy toward Poland. That conference, supported by a grant from The Ford Foundation, assembled a group of academic specialists on Poland, present and former government officials, and representatives of the Polish emigration to assess the Polish domestic situation and to consider premises and objectives of future policy toward Poland. A summary of the workshop proceedings was issued as RAND Report R-3545-FR, *United States Policy Toward Poland: A Conference Report*, by A. Ross Johnson (Chair) and Barbara Kliszewski (Rapporteur), May 1987.

The present Note focuses on Polish economic policy and considers ways in which Western policy levers can influence the Polish economic debate. The Note incorporates a number of comments and observations made during the RAND workshop discussions. It was prepared under the auspices of the National Defense Research Institute, the Office of the Secretary of Defense's Federally Funded Research and Development Center at RAND, as part of the Institute's research support effort, as well as with Ford Foundation support.



## SUMMARY

Economic policy instruments have played a major, if not the major, role in Western attempts to influence the course of events in Poland over the past decade and a half. These instruments primarily operate by attempting to influence the economic policy decisions of the Polish leadership.

Economic policy in Poland is partially dictated by the failures of the past. These have been notable. In the early 1980s, Poland experienced the worst economic performance of any industrialized country since World War II. The current leadership embarked on an economic reform to alleviate this crisis but has had very limited success. Rival groups in the party and government have stifled the reform. Endemic excess demand, poor export performance, and central allocation of goods and services continue to characterize the economy.

Polish economic policy has been a hodgepodge since 1982. Various groups within or associated with the government have formulated competing policies. In recent years, the National Bank has spearheaded efforts to expand the reform; heavy industry and the branch ministries have worked to slow decentralization. Wojciech Jaruzelski, the First Party Secretary, and more recently Zbigniew Messner, the Premier, have arbitrated among these competing interests. In great measure, the extent of Western economic leverage depends on how Western policies affect the interests of these various groups.

The West has several economic policy goals vis-a-vis Poland, but two appear to stand out: the eventual servicing of Polish hard currency debt and the implementation of a more efficient, market-based economic system within the country. The latter would make it easier for Poland to service its debt and could lead to increased trade and, possibly, a more open political system.

Western economic leverage appears to lie in its willingness to ease Polish debt repayment and to lower barriers to Polish exports. The application of this leverage will consist of trading concessions for concessions. Concessions on debt service may well be most fruitfully

traded for greater Polish efforts to increase exports. Concessions on Western barriers to trade could be traded for concessions on Polish barriers to trade. Pushing the Polish government to let individuals and enterprises, rather than the government decide the composition of the limited volume of Polish imports would probably improve economic efficiency and diminish the hold of the Polish bureaucracy on the economy.

The West may be able to successfully push for Polish policy measures designed to increase exports during ongoing talks on renegotiating the Polish debt held between Poland and Western governments (the Paris Club). Agreements to lower import barriers could be reached during the new General Agreement on Trade and Tariffs negotiations, the new CMEA-EC negotiations, or bilateral negotiations. In general, however, detailed discussions on changes in the Polish economic system will probably be confined to interactions between Poland and the World Bank and the International Monetary Fund. These institutions are international and do not represent the policy interests of particular countries. They also are able to extend substantial sums of money. Therefore, the Polish government is likely to heed their economic advice more readily than that of Western governments.

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## I. INTRODUCTION

Economic policy instruments have played a major, if not *the* major, role in Western attempts to influence the course of events in Poland over the past decade and a half. All too often the policy instruments employed seem to fit poorly with the goals policymakers hope to achieve. Too much is often asked of too little.

This Note is designed to clarify some of the linkages between past and current Western economic policies toward Poland and the formation of Polish *economic* policy. Western policy is, of course, directed toward influencing Polish policy in general, not just economic policy. Nonetheless, the Note should make some of the linkages between policies and influence clearer.

The Note describes the context in which Western economic policies directed toward influencing the policies of the Polish government will operate. It summarizes the current state of the Polish economy in relation to the period immediately before and after the imposition of martial law and describes current Polish economic policy goals and the instruments that have been employed to achieve these goals. It concludes with an assessment of the leverage embodied in Western economic policies in light of their potential effects on the Polish economy and the fulfillment of the economic policy goals of the Polish government.

## II. THE POLISH ECONOMY FIVE YEARS AFTER MARTIAL LAW

### MACROECONOMIC PERFORMANCE

Current economic policy in Poland is partially dictated by the failures of the past. These have been notable. After recording significant increases in output in the early 1970s, the Polish economy suffered a drastic decline in output in both 1981 and 1982 (-12.0 and -5.5 percent, respectively).<sup>1</sup> This is the worst economic performance recorded by any industrial country since World War II. The decline in 1981 was due in part to sharp declines in hard currency imports, but also in part to the rigidities in the distribution system. As the quantity of intermediate goods available declined, the remainder was not allocated to its most efficient use. Consequently, the decline in output in 1981 was greater than would otherwise have been the case.

Most of the decline in 1982 took place in the first quarter after the declaration of martial law. Martial law abruptly curtailed the economic upswing which began in October 1981, especially in coal output. Part of the drastic fall in output in the first quarter of 1982 can be attributed to the imposition of martial law itself. Transportation and communication systems were subject to rigid controls and some factories were closed for fairly long periods. The continued reduction in the level of hard currency imports also contributed to the decline.

The recovery from the 1979-82 Polish recession has been slow, but it continues; increases in net material product have averaged 4.9 percent per year since 1982. This is a low rate of growth for a country emerging from a recession, especially since Polish economic output has yet to regain its previous peak recorded in 1978. Output in all major sectors (industry, agriculture, and construction) has risen since 1982, although most of the rise in output in 1985 and 1986 has occurred in industry, especially the machine-building sector. As noted by Michael

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<sup>1</sup>The figures cited here and below are taken from *Rocznik Statystyczny 1985* or *Biuletyn Statystyczny* unless otherwise specified.

Montias, part of these increases consist of "junk" industrialization: the production of machinery which is difficult, if not impossible to sell on world markets because foreign substitutes are so superior in terms of efficiency and quality.<sup>2</sup> Thus the value of this type of production tends to be inflated in Polish statistics.

Because of the limited increases in economic output, consumption and investment have also failed to return to their previous peaks. Per capita consumption is not expected to reach 1978 levels until the 1990s. Annual increases in real personal consumption between 1983 and 1986 have been moderate, averaging 4 percent per year (per capita levels have been substantially lower). Collective consumption has held up better; it presently exceeds 1978 levels. Investment, although increasing at a more rapid rate than consumption, is still at little more than half the 1978 level.

Probably one of the greatest disappointments in macroeconomic policy for the Polish government has been the failure to generate overall macroeconomic equilibrium. Although consumer price inflation has been high by historical standards, averaging 17.5 percent per year since 1983, the markets for consumer goods, especially automobiles and some other consumer durables, continue to be plagued by shortages. Equilibrium in markets for foodstuffs, on the other hand, has improved. The government has been able to abolish rationing of a number of foods while maintaining fixed prices.

Poland's macroeconomic performance has also been disappointing, at least for its creditors, in the ruble and hard currency current account balances. The Soviet Union continues to permit Poland to run large deficits in bilateral trade. Poland is now the largest ruble debtor to the Soviet Union among the members of the European CMEA and appears to be the only one which has not been forced to reduce its ruble trade deficit in recent years. Poland's other partners in the CMEA, with the exception of the German Democratic Republic (GDR), are more hard-nosed than the Soviet Union. Their trade with Poland remains roughly in balance, or the deficit is on their side, not Poland's.

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<sup>2</sup>Personal communication.

Poland has recorded a surplus in hard currency trade since 1982, but the surplus has never been large enough to pay the interest, let alone the principal due on Poland's hard currency debt. At their peak in 1985, hard currency earnings covered 75 percent of interest payments owed; this year the percentage will be less. Consequently, Poland's hard currency current account has remained in deficit. Because of Polish accounting idiosyncracies, under which interest owed but not paid was not recorded, Polish statistics did not list the actual size of the deficit until recently. Estimates indicate it has run \$600 million to \$1500 million a year since 1982.<sup>3</sup> Poland's creditors have responded to lack of payment by transforming interest into principal. As a consequence, Poland's hard currency debt now exceeds \$31,200 million; in 1980 it ran about \$24,000 million. My projections of the size of the debt in 1990, which are based on optimistic assumptions, are from \$36 billion to \$37 billion.<sup>4</sup>

#### ECONOMIC REFORM

The Polish government made a number of significant changes in the way in which it runs the economy after the imposition of martial law.<sup>5</sup> Enterprise councils elected by employees were set up which ostensibly had the power to elect or at least veto the choice of managers. Enterprises were to become self-financing, which implied that profits were to be pursued or, at the very least, losses avoided; otherwise the enterprise could be closed. Moreover, a firm's future development was to be contingent on profitability: investment was to be financed from retained profits or bank loans granted on the basis of the expected rate of return. Ministerial controls on managers were to be reduced and if possible eliminated; managers were to be independent, accountable to the workers' council and intent on increasing profits and value-added.

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<sup>3</sup>*East-West*, November 28, 1986, No. 128, p. 8.

<sup>4</sup>Keith Crane, *Polish Balance of Payments and Output in 1990: Alternative Scenarios*, P-7157, The RAND Corporation, November 1985.

<sup>5</sup>For the legal outlines of the reform, see "Ustawa o przedsiębiorstwach państwowych," *Trybuna Ludu*, September 28, 1981, p. 5.

For this system to function efficiently, markets were to play a more important role in the economy. Prices of a large number of non-essential consumer goods and intermediate products were to be set by markets. Competition was to be encouraged. Enterprises were to be allowed to start the production of goods outside their traditional areas. Cooperatives, private individuals, local governmental units, and overseas Poles were allowed to set up enterprises in several industrial sectors.

Within this new system, the role of the government was to change dramatically. Indirect indicators like the exchange rate, interest rates, taxes, and subsidies were to be used to steer the economy. Most important, because of the change in the control of enterprises and in managers' objectives, the government was no longer to assign plan targets to enterprises. Enterprises were to draw up their own plans, but managerial and employee bonuses were no longer tied to plan fulfillment, as was previously the case. Although the role of the government in the economy was not to decline, it was supposed to change radically.

The reform has not been a success; whether it has been a total failure continues to be argued in both Poland and the West. The critics of the reform have a conclusive body of anecdotes and data to show that the reform has not operated as planned. Most telling are the continued role of the associations and ministries in the allocation of inputs and the lack of a rational system for setting prices. A very high percentage of inputs (over 50 percent by value) are rationed through quotas rather than distributed by markets.<sup>6</sup> Consequently, an enterprise manager has to stay within the good graces of the minister, association head, or other bureaucrat who controls these inputs, if he hopes to get a share. This state of affairs sharply limits a manager's freedom of action. Association presidents and branch ministries continue to be interested in output figures, not profits. Enterprise managers are therefore forced to push for higher production rather than reduce costs

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<sup>6</sup>Jan Lipinski and Urszula Wojciechowska, *Proces wdrażania reformy gospodarczej*, Państwowe Wydawnictwo Ekonomiczne, Warsaw, 1987, p. 19.



or alter their production profile toward more profitable products, because of pressures from the center or branch ministries. Moreover, these organizations have tended to preserve the former structure of production, propping up loss-making firms through their control of investment funds and subsidies and drastically circumscribing the role of the markets in setting prices and allocating resources. Consequently, the efficiency gains which should have been generated by the reform have been far less than one would have expected, given the endemic waste in the Polish economy. On the other hand, some Polish firms have gone bankrupt; cost control and profitability have become more important.

The other major stumbling block for the reform has been the government's equivocal attitude toward prices. Much as under the old system, prices are to provide a "fair" profit to the enterprise. They reflect costs, but not demand. Moreover, some prices must be set at "fair" levels; otherwise the products are "too expensive." Consequently, prices of most important consumer goods and raw materials are set by the government and periodically revised, although after a political struggle in the case of consumer goods. Manufactured goods are then set on a cost-plus basis, using these fixed raw materials prices as a base.

This system continues to give Polish enterprises all the wrong signals. Food processing plants often face profitability problems because output prices are controlled. Manufacturers of machinery and consumer durables have had more leeway in setting prices and have benefited from the fixed prices of their inputs. Consequently, they have not faced a profitability squeeze. A decline in demand has yet to hurt enterprises, because growth in the money supply through the payment of subsidies to loss-making firms has kept nominal demand growing and price controls have prevented prices from equilibrating demand and supply in many markets. The resulting endemic excess demand has kept almost all enterprises profitable. The lack of a rational system of market-clearing prices has discouraged the government from relying more on profitability indicators in evaluating enterprises and has solidified the position of the branch ministries and associations, allowing them to use their influence to push managers to pursue ministerial, rather than enterprise objectives.

The problem has been even more pronounced in the foreign trade sector. Because the zloty continues to be overvalued, enterprises find hard currency imports relatively cheap compared with domestically produced inputs or those imported from the CMEA, when quality is factored in. Hard currency exports are not as lucrative as sales on the domestic market, so increases in manufactured exports have been slow, and those of machinery have even declined.

On the other hand, some successes can be traced to the reform. The policy of treating private and state-owned farms more evenly and of easing restrictions on private farming while increasing procurement prices has been successful. Polish agriculture has outperformed all other economic sectors in the 1980s. Global output by private manufacturers has doubled in real terms since 1978, while the output of state-owned industry has declined. Anecdotal evidence indicates that some Polish enterprise managers have become more entrepreneurial and cost-conscious and some workers' councils have a significant voice in running the enterprise.<sup>7</sup> Moreover, even if output statistics in the machinery sector have been inflated, productivity increases in Poland over the past four years have been significant. They have accounted for almost all recorded growth. It is difficult to explain these increases without giving some credit to the economic reform, especially as enterprise managers have had somewhat greater freedom to set wages so as to reflect performance and to pursue more profitable areas of production.

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<sup>7</sup>Seminar on Self-Management, Institute of Sociology, Warsaw, March 1987.

### III. ECONOMIC POLICY AND THE POLISH GOVERNMENT

The Polish government, like all governments, consists of and responds to groups of individuals with competing interests and goals. It is not surprising that it rarely speaks with one voice. Nonetheless, if Western economic leverage is to be effectively applied, some idea of the groups participating in economic policymaking, their goals, interests, and favored policies needs to be formulated so the potential effects of various Western policy instruments on Polish economic policy can be better assessed.

#### ACTORS

Although the Poles are now more forthcoming in terms of leaking policy debates to the press, neither the policy positions nor the relative importance of the various groups within the party, government, and government-sponsored institutions is always clear. Consequently, much of this section rests on inference and speculation. Nonetheless, the following actors appear to have pushed for policies which have either been adopted or have affected the implementation of official policy in Poland.

#### The First Party Secretary

Wojciech Jaruzelski and other leaders drawn from the military do not appear to have had a strong intellectual influence on the economic reform or the direction of economic policy. It is difficult to garner from their statements specific economic policies which they favor, other than more work discipline and better management.<sup>1</sup> Jaruzelski has reiterated his firm opposition to any return to pre-Solidarity practices. This appears to imply that the government opposes a return to directive planning, as well as corruption, i.e., Jaruzelski strongly supports a different, "reformed" economic system. However, he does not

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<sup>1</sup>For example, see "Messner Interviewed on Economic Reform, Debts," *FBIS*, September 9, 1986, p. G 12.

seem to have a preference for a particular mix of markets and price controls or private and public enterprise. His role appears to be as arbiter of competing policies within the government. This role has been taken over to some degree by Zbigniew Messner, since his appointment as Prime Minister.

### The PUWP

It is difficult to find an area where the Polish United Workers Party (PUWP) has left a significant mark on the theoretical foundations of the reform. The Central Committee and the Secretariat appear to reflect the debates within the government concerning the direction of economic policy: both those favoring a more consistent implementation of the reform and those arguing for special dispensations for particular industries are represented on the Central Committee. Neither group is a consistent winner.

The party as a whole probably favors tighter central controls, but no group within the party has produced a coherent alternative to the present muddled reform. The policy discussion at the 1986 Party Congress often centered around populist moves--criticizing price gouging in the private sector and calling for more discipline and tighter links between wages and output.<sup>2</sup>

### The Reformers

Wladyslaw Baka, President of the National Bank, was formerly Special Minister for the implementation of the reform. His public statements indicate that he has a healthy respect for the market and advocates greater use of market prices within the Polish economy and a tougher line vis-a-vis loss-making enterprises.<sup>3</sup> He also appears to be aware of the need to rationalize the price system. His views appear to be supported in part by the Ministry of Finance and the Association of Polish Economists.

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<sup>2</sup>See reports on the 10th Party Congress held in 1986.

<sup>3</sup>Wladyslaw Baka, "Some Thoughts on the Economy and Sound Money," *Contemporary Poland*, No. 11, November 1986, pp. 9-12.

Both the Ministry of Finance and the Central Bank have important roles in the reform. They have taken over much of the authority previously given the branch ministries. The Ministry of Finance controls prices and sets tax and subsidy rates. Because it is also concerned with balancing the budget, it places a much greater emphasis on profitability and a smaller emphasis on investment and production than the branch ministries. These emphases contribute to the push for reform. Because the Central Bank provides the finance for investment, it is concerned with the rate of return of projects and the financial health of enterprises. Thus it has a much stronger interest in efficiency and the reform than do other governmental agencies.

### **The Regulators**

The Ministry of Finance in its role of price controller and the Ministry of Labor, Wages and Social Affairs have been most concerned with wage inflation. They have been active in introducing new regulations and directives to limit wage increases.<sup>4</sup> Many of these regulations are inconsistent with a market-type reform and consequently are detrimental to the prospects of successfully improving the system.

### **The Metal Eaters**

Vice-Premier Szalajda has been identified as a supporter of the heavy- industry lobby, which is especially concerned about the continued flow of investments to heavy industry. These individuals often support recentralization because it would, they hope, lead to increased investment in their preferred industrial branches. In recent years, several initiatives have emerged from the Ministry of Mining and Power and the Ministry of Metallurgy and Engineering to recentralize control of enterprises in their industries, the most recent being an attempt to force enterprises in the electronics industry to join a centrally controlled association.<sup>5</sup>

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<sup>4</sup>"Observations on the Economic System," *Zycie Gospodarcze*, No. 42, October 16, 1983, p. 7.

<sup>5</sup>This initiative by the Minister of Metallurgy and Engineering was voted down by the enterprise managers in the industry.

### The New Unions

The new government-sponsored labor unions have, like the party, but more successfully, adopted a populist approach. They have argued for continued subsidies and central guarantees on wage rates for particular job categories, a move which would limit enterprise autonomy in setting wages. At times they have also clashed with enterprise workers' councils over prerogatives. They generally oppose greater use of markets and broader enterprise autonomy and favor price controls on consumer goods.

### The Foreign Trade Constituency

The Ministry of Foreign Trade, in conjunction with the Foreign Trade Bank, is the body most concerned with Poland's external balance. The Ministry has pushed for more incentives for hard currency exports and has played an important role in permitting enterprises to retain hard currency earnings in special accounts. Enterprise managers are supposedly free to use these accounts as they wish.<sup>6</sup> The Ministry of Foreign Trade has also pushed for continued devaluations of the zloty. It has generally supported efforts to decentralize the economy and rely more on market prices, especially world market prices.

### PRIMARY POLICY GOALS

In 1982 the policy goals of the Polish government were obvious. The first order of business was the suppression of Solidarity. This was satisfied by the imposition of martial law, the arrest of most of the organization's leadership, and the breakup of strikes through threats or the ZOMOs, the riot police.

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<sup>6</sup>Between 1982 and 1987, enterprises received the right to repurchase hard currency from export proceeds. Since 1987, enterprises own the hard currency. Under the new system, the enterprises can only exercise their former rights of purchase over the course of the next five years. Although enterprises now have stronger legal rights to keep part of their hard currency earnings, the new rules have actually abrogated enterprise rights to purchase over \$1.5 billion in 1987 built up under the old system.

Following the suppression of Solidarity by the regime, the next order of business has been to increase output. The sharp increases in prices in February 1982 helped restore equilibrium on some intermediate and consumer goods markets. Because Polish farmers could now purchase goods which were previously in short supply, this move probably contributed to the increase in agricultural output recorded in 1982. Lengthening the workweek in the mines, coupled with increases in output bonuses, helped increase the production of coal and some minerals and metals. The expansion of the private sector led to a rapid increase in privately produced output and probably removed some bottlenecks. The introduction of the economic reform may also have contributed to a more rational use of capacity and labor and increased output.

## SECONDARY POLICY GOALS

These two policy goals, the suppression of Solidarity and the restoration of economic growth, were achieved by the end of 1982. They have remained primary for the Polish government. However, other, secondary goals have since emerged to occupy the government. These goals have often conflicted. Government vacillation in choosing among them has contributed to the lack of success of the economic reform and has engendered a series of continuing problems. These secondary goals include:

- Increasing economic efficiency
- Attaining single-digit levels of inflation
- Attaining market equilibrium
- Maintaining real wages among politically sensitive groups
- Preventing unemployment
- Increasing investment
- Servicing the debt

## Single-Digit Inflation, Economic Efficiency, and Market Equilibrium

The very rapid rates of inflation in recent years (averaging over 20 percent since 1982) have been highly unpopular with most of the

Polish populace. It is not clear whether this unpopularity reflects the perception (or reality) of declining real incomes or discontent with fluctuating prices after years of relative price stability. In any event, it is not surprising that reducing the inflation rate has been an important policy goal.<sup>7</sup>

The government has pursued this goal by placing price controls on many consumer goods and trying to control wage increases through central directives. The Ministry of Finance and the Ministry of Labor, Wages and Social Affairs have been most concerned with wage inflation. They have concentrated on drawing up directives to limit wage increases, including regulations that prohibit workers in high demand from changing jobs for higher rates of pay. This regulation has been less than successful. The Ministry of Domestic Trade and Services has shared responsibility for prices with the Ministry of Finance. Both ministries have relied heavily on fixed and administrative prices to limit inflation.

Rarely has the government displayed the patience to rely on market forces to lower prices. For example, on February 1, 1982, the first day enterprises were given leeway to increase prices in the reformed system, newly posted prices for appliances and automobiles were severalfold higher than before. On February 2, 1982, these prices were promptly halved, not because of market forces, but through government intervention.

More recently, some sections of the government, especially the Ministry of Finance and the Central Bank, have focused on market equilibrium as a policy goal. They note the very high efficiency costs of allocating goods through queues, ration cards, and administrative fiat, rather than markets, and argue that these costs impose a major barrier to more rapid economic growth. They also argue that inflation can be reduced more effectively by decreasing the rate of money creation.

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<sup>7</sup>Baka, "Some Thoughts on the Economy and Sound Money," pp. 9-12.



However, such a policy would run into substantial political opposition. Inflation has remained high in Poland because the national budget deficit has been large and financed by money creation. To close the budget would imply sharp reductions in subsidies, the largest single budget category, or increases in taxes. Because most of the subsidies are used to keep the costs of food, public transportation, energy, and raw materials low, a reduction in subsidies would lead to an increase in food or transport prices or large input price increases for enterprises. The former would anger consumers; the latter would endanger the financial health of a number of manufacturing enterprises and, it is feared, would set off a round of cost-plus inflation as increased input costs are passed along in final output prices.

Another area earmarked for cuts is that of discretionary subsidies and tax rebates. Because prices in Poland are still subject to controls, enterprise managers can reasonably argue that the financial condition of their enterprise is due to government regulations, not their own inefficiency. This has led to a proliferation of tax exemptions and subsidies; an enterprise's financial performance has come to depend far more on its manager's ability to talk the Ministry of Finance into granting an exemption than on improving efficiency.

A fierce political battle is being waged over these exemptions. Everyone agrees that they are bad, but no one is willing to forgo them. Consequently, the Ministry of Finance and the National Bank are under constant pressure to reduce exemptions in general, but to grant them in particular cases. Some progress was made in making regulations more uniform in 1985 and 1986, but in light of the Hungarian experience, one would have to be very optimistic to believe that exemptions will not continue to characterize the Polish financial system.<sup>8</sup>

### **Unemployment and a Politically Determined Wage Structure**

One reason for the widespread use of exemptions and enterprise-specific subsidies appears to have been a fear of unemployment on the

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<sup>8</sup>Urszula Wojciechowska, "Wazna Lekcja," *Zycie Gospodarcze*, No. 18, May 3, 1987, p. 3.

part of some policymakers in the central government and a desire to placate politically important groups of workers, such as miners and workers in the steel and shipbuilding industries. Unemployment was a worry at the reform's inception. Early retirement was offered to all Poles working in state-owned enterprises at that time, and a large number of them took advantage of the offer. Almost immediately, enterprises began to complain of labor shortages, and a tight labor market has been in existence ever since.

Unemployment has not been a problem, because the central authorities have been loath to threaten firms with bankruptcy. The bankruptcy law was signed only in 1985. The major victim of the law has been a small metal fabrication firm in Zabrze in Upper Silesia. Until 1987, when Budapol, a large construction firm in Warsaw, came under fire, no major firm had been at risk. If the central authorities do decide to impose a "harder budget constraint" on enterprises, this problem may resurface, especially in areas with only a few enterprises or in the case of large enterprises in financial difficulty. So far, the central authorities indicate they will bail out any firm with financial problems whose closure could generate political problems.

A more pressing problem has been wages. The central authorities have intervened repeatedly in the labor market, with little regard to the economic consequences. At the end of 1982, a year when consumer prices doubled, the government granted a substantial unilateral wage increase which covered almost all workers in the economy. Before this increase, equilibrium was beginning to emerge in a number of consumer goods markets; after it, shortages reappeared and excess demand increased, but the government felt that the increases in nominal incomes would reduce political unrest. To some extent, this may have been correct.

The government has also been adept at targeting specific groups for wage increases. It is no accident that wages in coal mining are higher in real terms than they were before the recession. Workers in other industries in which Solidarity was strong have also continued to receive better than average treatment in terms of wages (Table 1). Pensioners, bureaucrats, and social service workers (teachers, hospital workers,

etc.) have experienced the largest declines in real incomes. Although some of the increased differentials between coal miners and other workers may have been economically warranted, political reasons also appear to have been important.

Table 1  
RATIO OF THE WAGES IN SELECTED INDUSTRIES  
TO AVERAGE WAGES

Industry	1980	1984
Coal mining	1.837	2.156
Ferrous metals	1.375	1.346
Transport equipment	1.089	1.060
Textiles	.941	.956
Health	.788	.783
Teaching	.805	.841

Source: Calculated from *Rocznik Statystyczny 1985*.

### Investment

Much of the burden of adjustment to the decline in output and closing the trade deficit has fallen on investment. Levels of investment, in constant prices, in 1985 were roughly half of those recorded in 1978. Enterprise managers now complain of decapitalization, as machinery and equipment have worn out and have not been replaced. Polish government and party leaders also voice concern about the widening technological gap between Poland and other countries.

The suggested solution to these problems is the same one that has been voiced ever since the imposition of central planning in Poland after World War II: more investment. It is a solution that has not been successful in the past and will probably not be successful in the future. It has also been difficult to implement this policy within the confines of the current economic system.

The economic reform envisages greater enterprise management accountability and more self-reliance, in terms of investment. As long as managers believe that an enterprise will be bailed out if the investment goes awry and they continue to be rewarded on the basis of the size of the enterprise they manage, rather than profits, the motivation to embark on large, new investment projects will remain strong. This appears to have been the case up to now.

The government has had to control the quantity of investment, since demand responds poorly to market signals. Control is exercised through the National Bank by vetting loan applications, ostensibly on the basis of expected rate of return and the financial strength of the enterprise, or through direct investment grants from the budget. The latter activity, which has been greatly reduced in Hungary, another reformed centrally planned economy, still accounts for over a third of investment in Poland. Its continued importance means that the government controls most investment decisions. This state of affairs bodes ill for a surge in the efficiency of capital investment in Poland, and thus the solution of increased investment is unlikely to lead to an acceleration in Polish economic growth.

### **Servicing the Debt**

This policy goal is discussed last because the Polish leadership appears to have given it the lowest priority among secondary policy objectives. In contrast to the GDR or Hungary, which have made a concerted effort to get their financial houses in order, or Romania, where debt repayment was given a very high priority, the Poles are still engaged in reschedulings of both guaranteed and unguaranteed debt. After an initial sharp reduction in the hard currency current account deficit in 1982 and 1983, the deficit has begun to widen again; the debt continues to increase. Although part of the problem is the sheer size of the Polish debt, Poland's recent lack of progress in reducing the current account deficit probably stems from the low priority given hard currency debt service.

The Polish government has probably accorded hard currency debt service a low priority because of political pressure to improve the standard of living and because it found it could use Western economic sanctions as an excuse to avoid servicing the debt. Moreover, the constituency within the government that has pushed to accord debt service a higher priority appears to be confined to a few individuals within the National Bank and the Ministry of Foreign Trade. Other interests have had a much more important voice in government decision-making.

Although there appears to be little push to balance the hard currency current account in Poland, the declared policy of reorienting Polish trade toward the CMEA does not appear to be pursued with any conviction. Hard currency exports continue to be given a higher priority than ruble exports. Most exports of "hard" goods (coal, foodstuffs, minerals, etc.) continue to go to the West, and factory managers are more highly rewarded for increasing hard currency exports than ruble exports.

Ruble imports have held up much better than hard currency imports since 1982. This is not surprising in view of the Soviet Union's willingness to let Poland run ruble trade deficits. On average, Poland's ruble exports have also increased more rapidly than hard currency exports since 1982, but in 1983 and 1984, hard currency exports posted the more rapid rate of increase. Poland has enacted new joint venture legislation to encourage Western firms to invest in Poland and continues to welcome, although in a less friendly fashion than in the immediate aftermath of martial law, the investments of expatriate Poles. These are not actions taken by a government determined to sharply reduce its economic ties with the West. Rather, they reflect Poland's attempts to adjust to its severe balance-of-payments problems

#### IV. WESTERN ECONOMIC LEVERAGE

##### SOURCES OF ECONOMIC LEVERAGE

U.S. and West European economic sanctions were imposed to induce a change in behavior in the Polish regime, to indicate that actions taken that run counter to Western interests have consequences, and to reflect outrage at martial law and the suppression of Solidarity. Although to a great degree symbolic, the sanctions did impose some economic costs on Poland; their removal has provided some economic benefits.

As noted in the previous section, Polish economic policy has been a hodgepodge since 1982. Various groups within or associated with the government have formulated competing policies, and Jaruzelski and more recently Messner have arbitrated among these competing interests. Consequently, Western economic leverage depends largely on how Western policies affect the interests of these various groups.

There are four broad areas in which Western policy can offer something of economic interest to some of these groups:

- Western banks and governments can refinance or advance loans to Poland, thereby reducing principal or interest payments due in any one year, but increasing the debt burden in the long term.
- Western governments can lower barriers to trade, easing the entry of Polish goods on Western markets, thereby facilitating greater gains from trade for Poland.
- Western governments can advance commercially beneficial economic rights such as access to fishing grounds, landing rights, etc.<sup>1</sup>
- Restrictions on the flow of technologies may be eased, thereby expanding the set of available technologies to Poland which could lead to increases in economic efficiency.<sup>2</sup>

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<sup>1</sup>In general, Poland faces the same obstacles to obtaining these rights in Western Europe or the United States as other countries.

<sup>2</sup>NATO members and Japan control exports to Warsaw Pact countries of goods that could affect war-making potential through an institution called COCOM. One of the sanctions applied by the United States to

By the same token, the West can impose economic costs on Poland by refusing to undertake these measures.

## **WESTERN POLICY GOALS**

Although this Note does not offer a detailed discussion of Western policy goals vis-a-vis Poland, a short list of possible Western foreign policy goals to be pursued through economic policies follows. The list provides one answer to the question of what Western leverage may be used for.

Two of the original Western policy goals set down in 1982 have been satisfied: martial law in Poland has been repealed and all (or virtually all) political prisoners have been freed. The U.S. government appears to have altered the third goal, the reinstatement of Solidarity. The Polish government is now enjoined to conduct a dialogue with society. This appears to mean that the government should incorporate more non-party elements into the governing process, either through consultation or through the appointment of non-party personnel to positions within the government.

The degree to which Western economic sanctions have contributed to the achievement of these policy goals is an open question. They appear to have been somewhat successful in encouraging the Polish government to release political prisoners. Whether they have influenced Jaruzelski to end martial law or seek more pluralistic policies is doubtful.

However, to focus future Western economic policies solely on the achievement of a more open political system seems too narrow a goal. Although the political process within Poland continues to be of concern to Western governments, several other policy concerns also exist. Among these are Poland's role in the Warsaw Pact, Poland's potential contribution to or drain on the Soviet Union, and Polish positions in international political forums. For the sake of brevity, the following discussion concentrates on two such concerns: the timely servicing of Poland's debt to the West and the establishment of a more open, more market-oriented economy.

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Poland was a blanket exclusion of exceptions on controlled exports. This restriction was removed in November 1986.

Western interests in inducing the Polish government to service its debts are self-evident. The case for encouraging the Poles to establish a more market-oriented economy is also strong. Such a system would probably improve Polish economic performance, thereby improving the economic welfare of the Polish people and making it easier for Poland to service its debt. It could also lessen the economic influence of the Polish bureaucracy and the PUWP on the daily lives of individuals. A more market-oriented system could foster a greater role for interest groups other than those within the party, thereby contributing to a more pluralistic system. For these reasons, fostering the market elements in the Polish economic reform is a policy worth pursuing.

## WESTERN LEVERAGE ON POLISH POLICIES

### Debt Negotiations

According to statements by Jerzy Urban, the Polish government spokesman, Western, and especially U.S., economic sanctions caused substantial economic damage. The removal of the sanctions, therefore, should provide various economic benefits. Although Urban rarely spells out what improved relations with the West will bring, he appears to focus on the possibility of debt relief. Polish declaratory policy indicates that the leadership perceives potential Western benefits from debt relief as large, although recent statements by Urban, Wladyslaw Baka, and Jaruzelski indicate that the Polish government has moderated its expectations.<sup>3</sup>

Current Polish estimates of the cost of the economic sanctions run to billions of dollars. Although it is hard to take these estimates seriously,<sup>4</sup> they reflect the belief that the sharp fall in Polish output

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<sup>3</sup>"Jaruzelski Speaks with Foreign Journalists," *FBIS*, December 2, 1986, p. G 8.

<sup>4</sup>The calculations appear to rest on the premise that Poland would not have had to make the balance-of-payments adjustment it did in 1981-82, because the West would have continued to advance new loans. Since Poland was uncreditworthy at the time, the only rationale for advancing new loans would have been political. This rationale disappeared with the advent of martial law. The calculations also ignore the 100 percent de facto rescheduling Poland received on its debt owed to or guaranteed by Western governments. Neither interest nor principal was paid during the two years following martial law. No other



in 1981-82 was due to the abrupt decline in hard currency imports. A one-time increase in hard currency imports made possible by additional loans would therefore result in a surge in output and hard currency exports, which would be self-sustaining.

To the extent that Polish leaders believe this analysis, Western governments and banks possess substantial leverage. By noting that future loans are contingent on prompt servicing of existing loans, Poland's creditors have been able to obtain some interest payments that might otherwise not have been made.

This leverage appears to have decreased recently as the Poles have begun to realize that "new" money will not be forthcoming in significant amounts. The Poles probably failed to realize the legal barriers they face in obtaining "new" money. Hermes, the West German credit guarantee corporation, has been unable to guarantee major new credits for Poland, because Poland has defaulted on previously guaranteed loans. The Export-Import Bank faces similar problems. Commercial banks could face stockholder suits if they attempted to expand their Polish exposure. For this reason, only the IMF is likely to advance "new" money to the Poles, and Poland's previous creditors would dearly like to see these funds used to repay some of their own loans to Poland.

Poland's economic performance also gives bankers little hope that the Polish economy would respond to an infusion of new loans with a burst of exports. My own calculations indicate that a one-time increase in Polish debt of 800 million SDR (about \$1 billion, or roughly the expected extent of Poland's drawing rights from the IMF), used to finance increased imports, would lead to a level of output 1.6 percent higher than would otherwise be the case five years later on.<sup>5</sup> This is equivalent to the difference in total output caused by a good versus a mediocre harvest. It is roughly one-fourth of the decline in output Poland suffered in 1982 and an even smaller fraction of 1981's fall.

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debtor in the world was able to arrange such favorable treatment. Although the disruptions caused by the credit cutoff, the denial of fishing rights to the Polish fleet, and the loss of Most Favored Nation (MFN) status probably cost the Poles several tens of millions of dollars, the gain from avoiding any payment on guaranteed debt for over four years may have left Poland with a net benefit.

<sup>5</sup>Crane, *Polish Balance of Payments and Output in 1990*.

Nevertheless, some incentives do exist for the Polish government to improve debt servicing. First, the IMF and the World Bank have the potential to provide some new money, but under the condition that Poland is current on the rest of its debts. Although net flows to Poland may be quite small, they are probably large enough to create a consensus within the Polish government to put greater emphasis on debt service. World Bank projects are especially popular among the "metal eaters," who have hopes of new investment projects. The "reformers" perceive both institutions as providing a renewed push for economic reform and economic equilibrium through political pressure and by providing a hard currency reserve that would make it possible to cushion economic adjustments.

A second motivation may be pride. The Polish government, especially Jaruzelski, has attached great importance to reestablishing its position within the international community. In practical terms, this has meant the restoration of high-level contacts between Polish and West European officials and, more recently, contacts with the U.S. administration. To some extent, it also has meant accepting Poland's debts and claiming that they will be repaid. It has probably provided some impetus for curtailing hard currency imports and pushing hard currency exports.

Another impetus for servicing the debt has come from the National Bank, Foreign Trade Bank, and Ministry of Foreign Trade. The directors of these institutions have spent a great deal of time trying to restore some order to Poland's finances. The aggravation and effort involved in settling Poland's accounts when Poland was a financial pariah were probably factors inducing them to come to terms with Western governments. Part of the interest of these institutions in restoring Polish creditworthiness stems from the problems caused by Poland's lack of creditworthiness in their day-to-day operations. For example, Poland still has to prepay most imports. This has created liquidity problems for the Polish National Bank, making it much more difficult to arrange for a smooth flow of imports. Shortages of imports disrupt production and have created a host of problems for Polish managers and foreign-trade personnel.

If this is the case, how should Western creditors use their limited leverage? The primary focus should be on encouraging the Polish government to increase exports. Although this runs counter to the interests of the trade unions and heavy industry, since the one is interested in increasing consumption and the other in increasing investment, it is the only way in which the debt will eventually be repaid. It is also one of the few ways in which the economic reform can be encouraged. Exports will materialize only if enterprises are given incentives to export. This implies that world market prices will have to influence the profitability of domestic production, that excess demand in the domestic economy will have to be reduced, and that the zloty will have to be devalued. All these measures should increase the role of markets in the domestic economy and thereby increase economic efficiency.

Governments should also apply pressure to make greater use of markets within the Polish economy. Since this is a sensitive issue and because it is a role the IMF and World Bank frequently play elsewhere, this type of pressure is probably best provided by these institutions.

Somewhat paradoxically, over the long run, servicing the debt may not necessarily be detrimental to the Polish consumer. To the extent that the debt burden forces the Polish government to make policy decisions that will make the economy become more efficient, servicing the debt will have a beneficial impact on the long-term economic health of the country. In light of the scale of economic waste in Poland, it is very possible that the current account could be balanced without a decline in domestic absorption, if efficiency gains are large enough.

### **Reducing Barriers to Trade**

Implicit in Polish complaints concerning the damage inflicted by U.S. sanctions is the premise that Poland will be able to increase exports to the United States substantially now that its MFN status has been restored. This implies that the Poles would be willing to grant some concessions in return for diminishing barriers to Polish exports.

The actual costs to Poland of the loss of MFN status and therefore the benefits from restoring it are difficult to calculate but do not constitute a substantial fraction of Polish hard currency earnings. The higher tariffs imposed after suspension applied almost exclusively to manufactured goods, often running 30 percent or more on these products. After the imposition of the tariffs, exports of manufactured goods to the United States fell sharply. Between 1980 and 1983, when the full impact of the tariffs was felt, Polish exports of manufactured goods declined from \$210.1 million to \$93.4 million. However, Polish hard currency exports in general, not just to the United States, declined dramatically in these years, from \$7956.8 million in 1980 to \$5401.8 million in 1983. Manufactured-goods exports performed more poorly than average. This being the case, Poland's internal economic straits must also account for a sizable share of the decline in exports to the United States. Moreover, these figures are gross, not net; they do not cover the cost of producing the products, nor do they reflect the diversion of the exports to other markets.

Thus, under the most generous assumptions, Polish losses from the imposition of tariffs were substantially less than \$120 million. This is less than 2 percent of Poland's hard currency exports. The restoration of MFN status is unlikely to lead to increases in the value of Polish exports to the United States of more than this figure.

Actual Polish expectations concerning the impact of lessening the barriers to trade on Polish exports are probably not high, implying that the concessions the Poles are willing to give are limited. Aside from the leadership and the Ministry of Foreign Affairs, the only other groups that had a strong interest in restoring MFN status were foreign-trade personnel and managers of firms with significant hard currency exports. In many cases, lower levels of exports lead to lower bonuses for these individuals. In other cases, they led to the closure of marketing subsidiaries in the West. Poles employed in these subsidiaries or traveling on business have access to hard currency. Because of the high value of the dollar on the Polish black market, even limited supplies of hard currency can enable a Pole to dramatically improve his standard of living. Thus these individuals have a strong desire to see barriers to trade reduced.

The theoretical leverage the West has in offering to reduce barriers to Polish exports to Western Europe or the United States, such as increases in Polish textile quotas, may be best used in pressuring the Poles to reduce their own barriers to trade. This may seem contradictory in view of Poland's need to increase its hard currency trade surplus, but it is really an essential step in generating future Polish exports and in making the economic reform function.

At present, the Polish leadership, not consumers or enterprises, decides what is to be imported. Consequently, the government is able to prop up inefficient industries by shielding them from import competition, and it often penalizes efficient industries by depriving them of needed hard currency imports. The system makes enterprise managers dependent on the associations and ministries that control hard currency quotas. Most important, the current system preserves past patterns of imports. Once an enterprise receives permission to import a product, it is unwilling to give it up, which often leads to inefficient use of imports. The system also imposes high transaction costs on exporters who incorporate imported components into their products. Reducing barriers to trade in Poland would force the government to rely more heavily on the exchange rate to achieve current account equilibrium and would expose enterprises to more competition, thereby forcing them to be more responsive.

## CONCLUSIONS

The extent of Western leverage in Poland is limited, given the overwhelming political, economic, and military importance of the Soviet Union for Poland. Nonetheless, economic policy instruments have some potential for influencing economic as well as other policies in Poland.

The West has several economic policy goals vis-a-vis Poland, but two appear to stand out: the eventual servicing of Polish hard currency debt and the implementation of a more efficient, market-based economic system within the country. The latter would make it easier for Poland to service its debt and could lead to increased trade and, possibly, a more open political system.

Whatever economic leverage the West has appears to lie in its willingness to ease Polish debt repayment and to lower barriers to Polish exports. Although these potential benefits are of interest to all members of the Polish leadership, they are probably of most interest to individuals working in the National Bank, Ministry of Finance, Foreign Trade Ministry, and export organizations.

Economic leverage is usually applied by trading concessions for concessions. In the case of Poland, concessions on debt service may be traded for greater Polish efforts to increase exports, which could be demonstrated by devaluations of the zloty and greater efforts to attain macroeconomic equilibrium. Concessions on Western barriers to trade could be traded for concessions on Polish barriers to trade. At present, the Polish economy is a closed economy; decisions on the composition of imports are primarily made by the central leadership. Trade discrimination is endemic to the system. By pushing the Polish government to let individuals and enterprises, rather than the government, decide the composition of the limited volume of Polish imports, economic efficiency would probably be improved and the hold of the Polish bureaucracy on the economy diminished.

The West may be able to successfully push for Polish policy measures designed to increase exports during ongoing talks on renegotiating the Polish debt held between Poland and Western governments (the Paris Club). Agreements to lower import barriers could be reached during the new General Agreement on Trade and Tariffs negotiations, the new CMEA-EC negotiations, or bilateral negotiations. In general, however, detailed discussions on changes in the Polish economic system will probably be confined to interactions between Poland and the World Bank and the International Monetary Fund. These institutions are international and do not represent the policy interests of particular countries. They also are able to extend substantial sums of money. Therefore, the Polish government is likely to heed their economic advice more readily than that of Western governments. They are probably the external institutions most likely to have an impact on the Polish debate on economic reform.